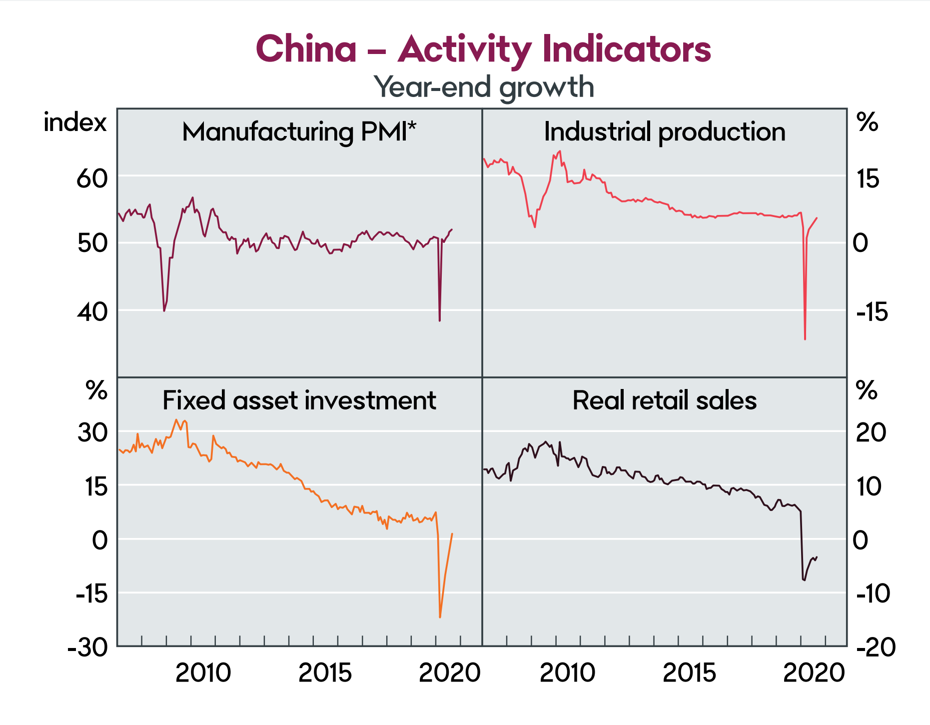
Economic and market update

Economic Overview – as of 22nd October 2020

Global markets

Stock markets remain relatively firm amid ever-increasing monetary and fiscal stimulus around the world. However late October promises to be a nervous period ahead of US Presidential elections and as COVID-19 cases experience a 'third wave' in Europe and North America in particular. News around a vaccine has been slightly more encouraging over the last week but remains a major swing factor for 2021. Those countries experiencing second and third waves are continuing to grapple with lockdown versus economic fallout and the degree of fiscal support ahead.



*Diffusion index; average of the official and Caixin
Sources: CEIC Data; Markit Economics; RBA

Global markets (cont)

The only major economy to have a higher level of GDP today than pre-pandemic is China. Their latest trade and activity data once again beat most forecasts with a 4.9% year on year rise in GDP for the September quarter. Importantly the largest improvement was in the services sector, and retail sales also picked up 3.3% year on year suggesting domestic demand is responding as hoped. Industrial production remains very strong rising 6.9% year on year in September, but the surge in Chinese imports (13.2%) and exports (9.9%) shows the economic recovery is not just in China but in the region. This augers well for Q4 data and for the recovery to be more sustainable.

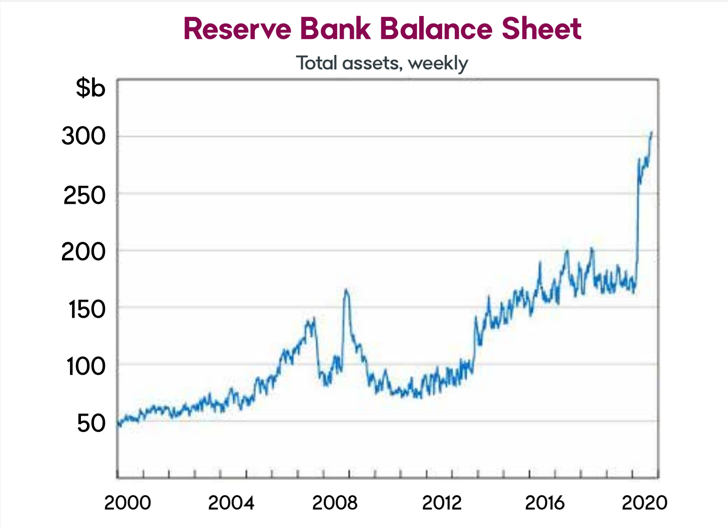
In contrast to this brighter picture in parts of Asia, the economic outlook in North America and Europe is more opaque. COVID infection rates will make international tourism and participating in 'travel bubbles' more challenging. In the case of the US the political brinkmanship on the next fiscal package is testing the patience of risk appetite. A democrat 'clean sweep' may accelerate the support package, however political uncertainty will dominate the markets for at least a fortnight. US economic data has been mixed, with the recovery in jobs markets losing momentum, but retail spending better than expected in September.

Euro-zone data has also been inconsistent and the mood in Europe has not been helped by rising COVID cases and the lack of progress on Brexit. Despite these challenges and the uncertain outlook for 2021, the latest IMF World Economic Outlook forecasts a 4.4% contraction for global GDP this year prior to a 5.2% rebound next year. This is mildly more optimistic than the previous forecast in June. Emerging and developing economies are forecast to clearly outperform advanced economies.

Domestic economy

The RBA has been transparent and insistent in October that it wants to provide more support to the economy, despite the strong fiscal response in the Federal Budget, and despite likely upgrades to their forecasts in the next Statement on Monetary Policy. This will create a unique Melbourne Cup week when the RBA will very likely cut the cash rate from 0.25 to 0.10% and announce significant increases to Quantitative Easing (QE), but days later the November Statement on Monetary Policy will upgrade the baseline GDP and jobs forecast for FY21. However, the latter will probably not change much beyond June 2021. RBA head Philip Lowe commented last week that the cash rate will not be increased until 'full employment' is actually reached - a more aggressive position than moving policy on projections rather than actuals.

The Federal Budget deficit of $213.7 billion (11% of GDP) was a record level of peacetime fiscal support. Its incentives for consumer spending (via tax cuts), business investment (via instant asset write off) and for jobs growth (via wage subsidies) was initially well received. Some of the euphoria has dissipated as thoughts turned to how readily businesses will respond to these incentives. However the commitment from the Government that fiscal stimulus will remain in place until the unemployment rate is safely below 6% gives some assurance that fiscal policy and monetary policy will move hand in hand, and support will not be removed until the economy is standing on its own two feet. This will see Government gross debt rise to over one trillion dollars by 2022. Much of this additional debt will end up on the RBA's balance sheet via QE but with ample demand for our bonds (similar bonds overseas have a negative yield, while ours pay a handsome 0.8% for ten years) this is the ideal time to leverage our AAA credit rating. This rating has been reaffirmed by the three major agencies since the Budget.



Source: RBA

Domestic economy (cont)

While domestic economic data has held up impressively through Q3, and should be resilient in Q4, the outlook for 2021, as per global markets, is still most uncertain. The unemployment rate may have already peaked at 7.5% in July and job losses turned the corner in May (refer appendix). Unemployment may remain elevated for much of 2021, perhaps within a 6.5 to 7.5 per cent band. The variables will remain broadly consistent: how resilient will consumer demand be in a COVID-safe economy? How will our trade relationship with China evolve? When will a vaccine be fully tested and available? That step from a COVID-safe economy to a post pandemic economy is crucial. Until then the economy may simply be treading water and will require further (affordable) support.

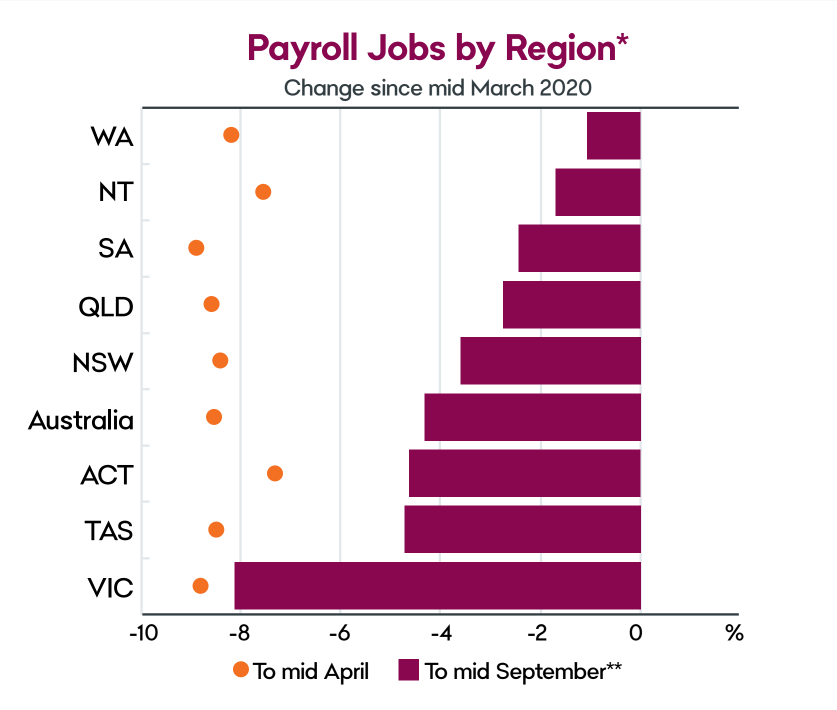
The Aussie dollar remains in a 70 to 74 cent band with stronger Chinese data and a weaker US dollar pointing to more gains next year. However short term pressure ahead of a likely RBA rate cut on Melbourne Cup Day and more QE is expected. COVID relativities should also support the exchange rate, although the pace of reopening borders will be important. On a trade weighted basis we are still quite cheap, with the Trade Weighted Index below 60. Both ends of the curve have reached fresh all-time lows with the three-year swap below 0.1% for the first time on record, and 90-day bill futures trading at 0.02%.

Interest Rate Outlook

The RBA is poised to cut the official cash rate in November from 0.25% to 0.10%, and will increase its level of QE, but is still not in favour of moving to negative interest rates. The target for three-year bonds of 0.25% may be lowered to 0.10%, and five-year bonds may also be targeted.

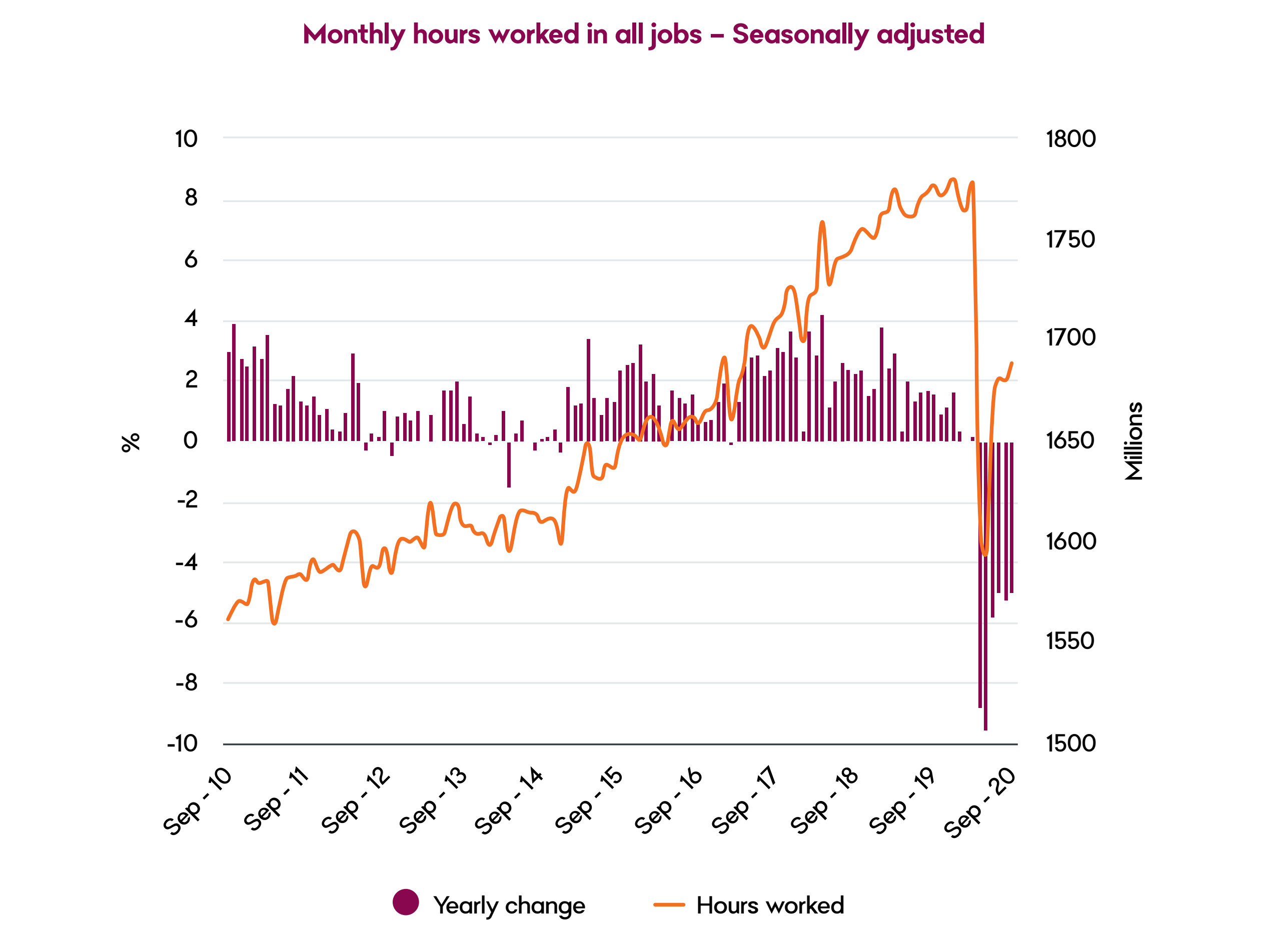
	31/8/19	31/8/20	30/9/20	**22/10/20**
90-day bills	0.95 %	0.09 %	0.09 %	0.06 %
3-year swap	0.74 %	0.19 %	0.14 %	0.09 %
5-year swap	1.07 %	0.38 %	0.31 %	0.25 %
AUD/USD	.6755	.7370	.7175	.7105
ASX 200	6 688	6 061	5 816	6 145
Credit Index (iTraxx- 5 yr)	67	65	76	65.4

Appendix



* Excludes businesses not reporting through single-touch payroll and self-employed persons
** Average of weeks ending 12 and 19 September 2020
Sources: ABS; RBA

Source: Australian Bureau of Statistics, September 2020



Source: Australian Bureau of Statistics, September 2020

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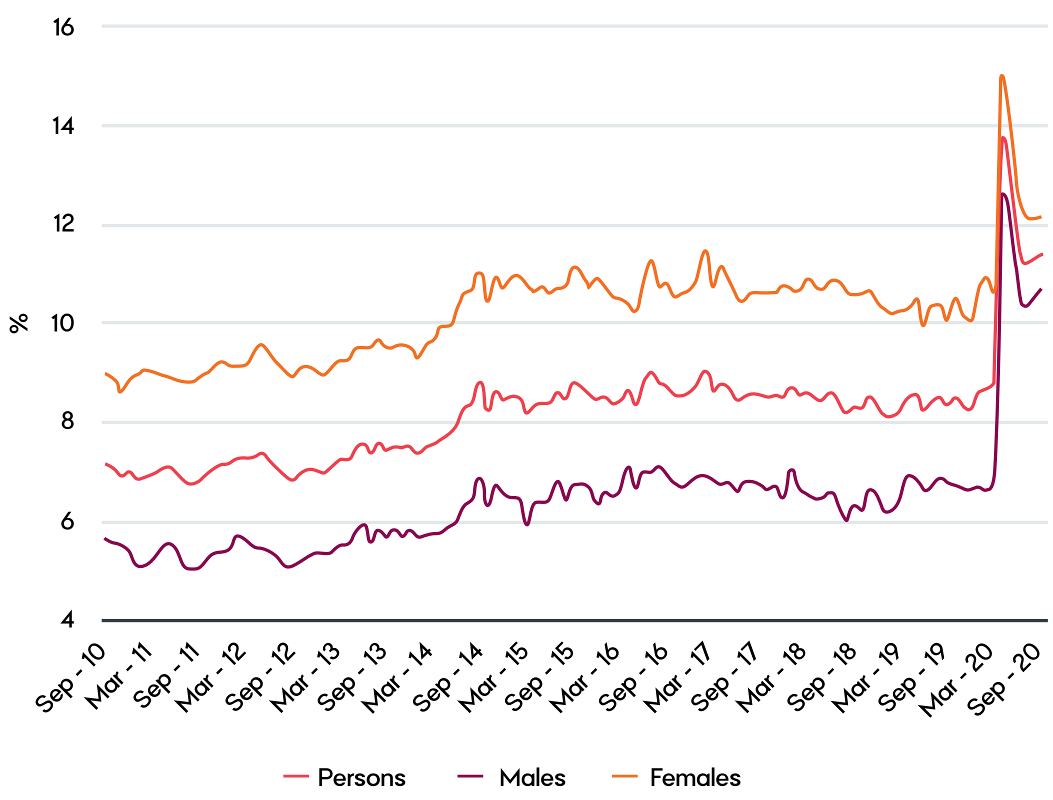
Underemployment rate – Seasonally adjusted



Source: Australian Bureau of Statistics, September 2020